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SUBJECT: TURKEY: LIMITED IMPACT OF INTEREST RATE HIKES

ANKARA 00005092 001.2 OF 002

¶11. (SBU) Summary. In its August 24 meeting, Turkey's interest rate setting Monetary Policy Committee (MPC) decided to keep Central Bank interest rates on hold at 17.5%. Since the global emerging market turmoil in May, however, the MPC has increased interest rates by a total of 4.25%, reversing the post 2001 financial crisis trend that had seen rates decline from 62% in February 2002. The MPC's firm response played a key role in staunching the outflow of foreign portfolio investment, stabilizing the exchange rate, and restoring some of the policy credibility that had been lost since Central Bank Governor Durmus Yilmaz took over as chairman in April. Yet, observers have argued that the rate hikes will have a depressing effect on real economic activity and growth at a time of increasing political sensitivity as 2007 presidential and parliamentary elections approach. While it does seem that GDP growth will slow this year and next from the torrid pace of recent years, most local economists see a relatively limited impact of the 4.25% increase on growth and employment, trimming a percentage point or so off their forecasts. Instead of 5-7% growth this year, growth will probably be in the 4-6% range. Growth will stay positive next year. End Summary.

Large Rate Hikes Part of Firm Response to Turmoil

¶12. (SBU) After a bumbling its initial response to May's and June's market turmoil, the MPC made the decisive decision beginning June 8 to reverse the downward trend in the Central Bank's policy rates. A cumulative rate increase of 425 basis points and a resumption of the Central Bank's daily lira auction intended to extract "excess liquidity" from foreign exchange markets seems to have a positive impact on markets' inflation expectations and to have stabilized the level of the currency, which had hit a low of 1.76 TL to the dollar.

The government's commitment to further tighten its fiscal surplus under the IMF program also helped reassure that Turkey had not lost its inflation-fighting zeal in the run-up to 2007 presidential and parliamentary elections.

¶13. (SBU) At the same time, local and foreign economists began to worry that the aggressive response to market turmoil would lead to a slow-down in the economy through curbed demand and delays in planned investment decisions as the cost of money increased. Indeed, the increase in market interest rates charged in the fast-expanding consumer loan sector had an immediate impact on consumer demand. Banks saw a booming credit card and housing loan growth come to an abrupt stop that was also reflected in a drop in domestic automobile sales (which was a big part of consumer demand growth). They worried that a spending slowdown could encourage populist political responses that would further stir markets.

Economists Relaxed, Seeing Continued Strong Growth

¶ 14. (SBU) Yet, most economists who observe the Turkish economy up close are sanguine about the impact of the rate hike, even in the short-term. For instance, Hakan Kara, Deputy Director of the Central Bank's Research Department, told us that the Bank did not see rate hikes having a large negative impact on growth, although he agreed that there would be a relative slow-down in consumer and business spending. He noted that part of the real interest rate increase would be offset by the increase in inflation expectations. Also, he thought that banks were likely to trim their interest rate margins and cut rates to spur lending as they accumulated new deposits. He pointed out that changes in banking regulations have decreased banks' ability to stash surplus funds in government securities, essentially obliging them to absorb increased interest costs instead of passing them on to customers.

¶ 15. (SBU) Another element offsetting a decrease in domestic demand would be a spur to external demand coming from the exchange rate depreciation. Most observers, including the Central Bank economists, expect this to be seen more in slower import growth than an increased rate of export growth. As noted to us by Central Bank Advisor Ercan Turkan, this could lead to industrial cost increases and a consequent slow-down in production since Turkey's domestic and export industries are heavily dependent on imported inputs. However, this has not yet been observed in the industrial production or corporate profitability statistics. Indeed, industrial production has surprised many economists with its continued strength, surpassing expectations in both June and July. At the same time, a reduction in Turkey's large current account deficit should have a positive impact on markets' perceptions of Turkey's financial vulnerabilities, theoretically leading to a lower risk premium and lower borrowing costs.

ANKARA 00005092 002.2 OF 002

GDP Growth Forecasts Trimmed Only Slightly

¶ 16. (SBU) There seems to be a consensus that the impact of the rate hikes will be felt most in the second half of 2006, when real GDP growth rates should fall below the 6.4% annual pace recorded in the first half. As a result, local forecasters seem to have trimmed on average about one percentage point off their 2006 outlooks. So, instead of 5-7% growth this year, economists are betting on a 4-6% range. At the low end, Fitch rating agency's local director told us her forecast was for 4.5% growth this year, similar to Global Securities' Murat Ucer's 4.4% prediction. Meanwhile, Baturalp Candemir, a widely quoted analyst for EFG Securities in Istanbul said he is expecting 5.5%. The Central Bank's Turkan expects growth to exceed five percent. This is a slowdown only when compared to last year's 7.4% pace. All of these economists expect the slowdown to continue to be felt in 2007, but with rate hike impact gradually diminishing.

Comment: Markets More Sophisticated About Turkey?

¶ 17. (SBU) In this troubled region and neighborhood, only the very brave forecast economic growth beyond the very short-term. Still, there appears to be a strong consensus that economic growth will remain strongly positive in 2006 and 2007 and that the impact of the recent rate hikes will be passing. Indeed, several of the economists we spoke to said that risks were "on the upside." Nevertheless, Turkey's economic and financial vulnerabilities remain including its large current account deficit and still substantial foreign-currency linked government debt that leave the country especially exposed to swings in global markets. Interestingly, however, a senior London-based Goldman Sachs Turkey watcher told us he saw markets growing more sophisticated in their approach to political risk in Turkey. He did not see major market fluctuations resulting from the inevitable political uncertainties

in a pre-election period. He thought this was due both to greater sophistication by investors as well as greater sensitivity of policymakers to the impact their comments have on markets. The recent smooth transition in the military command structure was, he thought, evidence of this.

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